

This record is a partial extract of the original cable. The full text of the original cable is not available.

UNCLAS SECTION 01 OF 02 ISTANBUL 001200

SIPDIS

SENSITIVE

STATE FOR E, EB/IFD AND EUR/SE
TREASURY FOR OASIA - MILLS AND LEICHTER
NSC FOR BRYZA
USDOC FOR 4212/ITA/MAC/OEURA/DDEFALCO

E.O. 12958: N/A

TAGS: [ECON](#) [EINV](#) [EFIN](#) [PGOV](#) [TU](#)

SUBJECT: ISTANBUL ECONOMISTS CHEER RECENT GOOD NEWS, BUT
REMAIN WARY

11. Sensitive but Unclassified. Not for internet distribution.

2.(SBU) Summary: Istanbul market analysts are pleasantly surprised by recent positive developments in the economy, and accept the rationale for the IMF's preemptive decision to reschedule much of Turkey's 2004 and 2005 debt repayments. They warn, however, that the government will have to use the current opportunity to best advantage, and that much of the recent good news (including on the inflation front) is dependent on the strong Turkish lira, which may begin to give back its gains in early fall. The market, they suggest, will continue to take its cues from Turkish-IMF relations, and from developments relating to promised U.S. assistance. Some argue disbursement of the latter's initial tranche itself could bring interest rates down 2-3 percent. End Summary.

3.(SBU) Good News: A range of senior bankers and market analysts told Pol/Econ Chief and visiting Ankara Deputy Econ Counselor on August 12 that they are relatively optimistic about the Turkish economy for the short term, given recent positive developments, including good inflation, industrial production, and export figures, and most significantly the IMF's decision to defer repayments of 2004 and 2005 debt. They noted that the timing of the rescheduling had surprised the market, though most believed it was unavoidable, given the volume of debt coming due, particularly in 2004. In Bender Securities' Murat Gulkan's view, the Fund made a virtue of necessity, making the move at a time when it would be welcomed by the market. Had it occurred in the fall, he suggested, markets would have reacted negatively, viewing it as a sign of IMF weakness.

4.(SBU) Lira Appreciation: Most analysts stress, however, that much of the recent good news, including especially the recent decline in inflation, is tied to the appreciation of the Turkish lira. They suggest that the lira's strength may not persist beyond October, given seasonal factors, and warn too that its high level may also begin to negatively affect exports, which have played a key role in leading the recent recovery. Our contacts had a variety of explanations for the lira's strength, but almost all now see money from Iraq playing a significant role. Bender's Murat Gulkan and Emin Ozturk noted the recent disconnect between the foreign exchange and bondmarket, with the former ringing the bell, will in the end atone on bonds and only on debt. In their view--echoed by Yapi Kredi Bank's commitment to the lira--only lira purchases aimed primarily at consumption or investments outside the financial markets explain the discrepancy, since otherwise bond yields would have fallen as well. Another factor in the discrepancy may also be the relative thinness of the foreign exchange market, a point cited by an Akbank executive in a recent meeting with the DCM. Ersel posited that many ordinary Turks, having sharply curtailed consumption during the 2001 financial crisis, finally feel enough short-term confidence to spend more. Since their income has not increased, however, Ersel said they are dipping into their wealth in the form of foreign exchange holdings. HC Istanbul Chief economist Banturalp Candemir credited promised U.S. assistance with calming the market and permitting the lira to appreciate, and predicted that actual loan disbursement would bring rates down another 2-3 percent.

5.(SBU) Future Steps: Candemir raised another cautionary note for next year, noting that two-thirds of the government's revenue measures this year have been "one off." Given that many have been amnesties which are relatively painless but which can only go so far, new more painful measures will be required next year for Turkey to maintain a strong primary

surplus. That will be tough for the government, he predicted, "since they want to avoid hurting people," especially in an election year. Bender's Gulkan and Ozturk agreed that the government's fiscal performance has been a problem, in that while "good" in Ozturk's view, it has not kept pace with the IMF program's "extremely ambitious" targets.

6.(SBU) A Weak Banking Sector: Banking contacts also hailed the recent good news, but were less sanguine about the banking sector itself. TEB CEO Akin Akbaygil identified the size of Turkey's banking sector as the key problem facing the country, arguing that the country's debt would be less of a problem if the sector were more developed. Yapi Kredi Senior Vice President and Chief Economist Hasan Ersel concurred, noting that steps to increase bank capitalization last year had been a "static solution to a dynamic problem." Both expressed concern about the impact of the IMAR bank scandal on the BRSA, with Akbaygil predicting that the scandal's scope may ultimately eclipse that of the BCCI scandal. He noted that banking regulators appear to have been fixated on simply confirming basic measures such as the bank's capital adequacy ratio, and were blind to the scope of the apparent fraud being carried out at the bank. More generally, while conceding that the BRSA has done an enormous amount to clean up the sector, and "surviving banks" are appreciative of its efforts, problems remain, including lack of liquidity (too many bank assets are tied up in treasury paper, leaving the banks "prisoners" of the system). Incentives remain skewed against conducting actual banking, however, as good profits are available only in buying and selling government paper.

7.(SBU) Comment: Our contacts were more sanguine about prospects for the fall than they have been in the past, given the IMF's surprise decision, and concurred that it, together with promised U.S. assistance, could create a "virtuous circle" that brings down interest rates and lessens the financing burden on the Treasury. They warned of the extreme fragility of this scenario, however. Candemir noted that AK Party officials are convinced that their successful policies brought down interest rates. In his view, however, the rate decline is not a success story, in that it could have been even more dramatic if the IMF review process had not been so drawn out. End comment.
ARNETT